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Cheeky Arista Takes On Cisco; Is It Different This Time?

If Arista is a credible threat to Cisco in switching, its shares could be a bargain at 40 times earnings.

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By TIERNAN RAY
February 21, 2015

Time was, the market for computer networking was a vibrant one, with numerous players, many of which dwarfed the challenger, [Cisco Systems](#), which came public in the dawn of the consumer Internet, in February 1990.

Cisco (ticker: CSCO) today is a \$150 billion giant, with most of the market to itself, and, as CEO John Chambers is fond of pointing out, his competitors have long since either exited from his market or folded outright.

Cisco is a survivor, but large enterprises always want alternatives. A challenger emerged in the public-equity markets last June, [Arista Networks](#) (ANET).

Run by former Cisco execs, including CEO Jayshree Ullal and legendary Silicon Valley genius Andy Bechtolsheim, its shares are up almost 60% since their debut, as it handily beat expectations in each of its three publicly reported quarters.

Results from Cisco and Arista in the past two weeks suggest Arista is indeed an increasingly credible threat to Cisco's dominance of the market for switching equipment, the fundamental piece of networking gear that connects PCs and networks of PCs together.

Arista is not cheap. After rising fractionally on Friday following better-than-expected results, the stock, at \$68.50, trades at 39 times this year's projected earnings per share of \$1.77. That compares with a mere 14 times for Cisco. As a multiple of sales, Arista fetches almost six times this year's projected revenue, double that of Cisco.

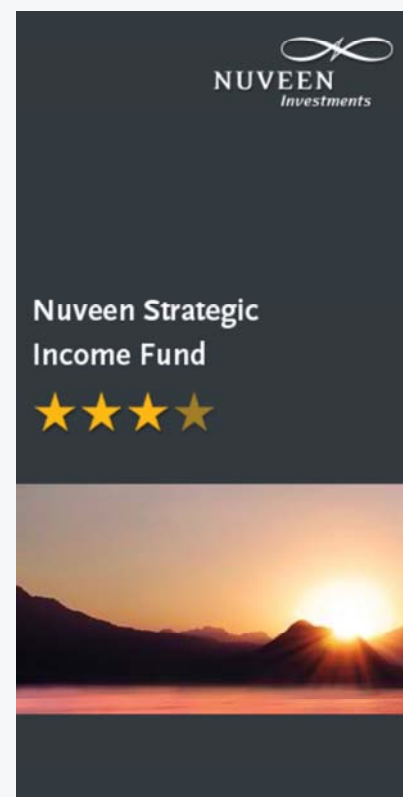
But perhaps it's worth it. With Arista turning in 50% revenue growth, and approaching \$1 billion in sales next year, it's becoming a substantial enough company to challenge Cisco's dominance.

ARISTA HAS GAINED a high profile because of a fascinating customer list. [Microsoft](#) (MSFT) has been its biggest customer, making up 15% of sales last year. [Facebook](#) (FB) is also a prominent client. And Arista has been known to sell into the high-frequency trading shops, which can use its switches to make trades automatically by parsing incoming stock information.

Asked by analysts last week if Arista is becoming a viable second-place vendor to Cisco in switches in the eyes of customers, Ullal replied, "Yes, I think, absolutely."

IT'S WORTH LOOKING at what happened last time a challenger became a viable No. 2 to Cisco. [Juniper Networks](#) (JNPR) came public in June 1999 vowing to give Cisco serious competition in the market for another piece of networking: routers.

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Two years after that bright start, Juniper's revenue was in decline, it had taken on nearly a billion dollars in debt, and it had loaded up on multi-hundred-million-dollar acquisitions, which brought high amounts of goodwill, leading to over a billion dollars in write-downs in subsequent years.

There are echoes in Juniper's rise of Arista's that give one pause, given how things unraveled for Juniper. Juniper was staffed by experienced networking industry executives, some with Cisco pedigree. Its revenue in 2000, a year after coming public, was similar to the \$786 million the Street expects this year from Arista.

Ullal told the Street last week the market is "much like with service providers, [to which] Juniper became the alternative source, [and now] Arista is clearly being viewed as the alternative innovator in data center."

Could Arista make similar mistakes, leveraging up and pursuing a spate of ill-considered acquisitions in a bid to keep the growth going? "It's a great strategic question," says Alex Henderson, who follows Arista, and Cisco, for Needham, and rates the former a Buy and the latter a Hold. "But the difference is, Juniper was selling into a telecom market that was smaller than the enterprise market," observes Henderson. "Cisco was able to subsidize its sales in the telecom market with its sales in enterprise, and put pressure on Juniper."

Arista, by contrast, is "going where the market is going," by selling into the Internet data centers of Facebook and Microsoft, which is also what all the enterprise customers—Cisco's bread and butter—want to build. Everyone wants to be a cloud computing company, and Arista is leading the way.

And if that is where the switching market is going, there's no way for Cisco to subsidize it this time, says Henderson.

It seems hardly necessary to point out things were different when the Nasdaq in 2000 was at levels it is now approaching. Juniper was caught in the dot-com excesses of the time; it was also caught up in the easy-money frenzy of M&A.

Ullal, whose switching company Crescendo was bought by Cisco when the latter was the size Arista is today, is mindful of not losing focus. "I don't rule out M&A, but the caveat is when your primary market is as large as [ours] is, you have to focus on what you do best—in our case software—and you have to stay true to the DNA of your company."

CISCO'S OWN RESULTS a week ago seemed to show the company is doing just fine, but there are signs it remains worried about Arista. Cisco's fiscal Q2 report showed an 11% rise in its sales of switching equipment. Headlines from Wall Street the next day said "Cisco is back!"—after a year or more of worries that Arista was eating its lunch.

But Cisco has also taken its case to the International Trade Commission, demanding justice for Arista allegedly having infringed on 12 of its networking patents. It has filed suit in California claiming Arista has infringed on copyright on the "command line," the very programming syntax that IT staff type to set the switches' functions.

In late 2013, Chambers told *Barron's* to "watch what happens" as the company unveiled its next switch, a start-up effort nurtured by the company, called Insieme, which would be an Arista "killer." Results from the report two weeks ago suggest Cisco is doing just fine with the new gear. But the decision to launch lawsuits in December also have a whiff of desperation after Chambers' insistence that plain old competition would win the day.

Henderson, who thinks Arista is indeed causing Cisco grief, is not impressed with the notion the incumbent is back. "They announced an 11% rise in switch sales, but that's compared with the year-earlier quarter where they saw a 12% decline!" he says. "That's not what I'd call a comeback."

If things are different this time around, if Arista can be a saner No. 2, its stock is worth a look even at its current price level.

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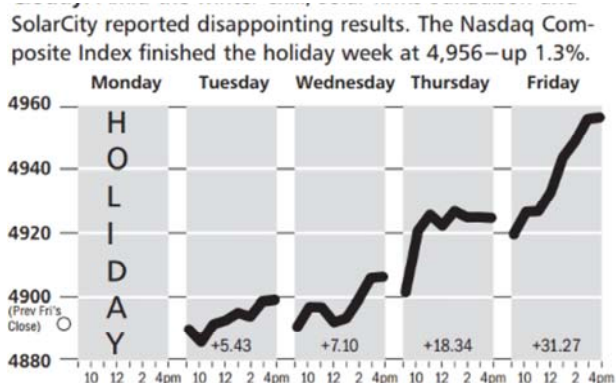


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